



Difference Makers

2006 Annual Report



A Message from the Chairman



I am honored to share with you Montana State Fund's (MSF) annual report for fiscal year 2006. It has been a rewarding experience to serve as Chairman and work alongside MSF employees. Through the years, this dedicated team has never lost sight of the fact that our organization plays a critical role in the economic and social well-being of the citizens of our state.

Our success lies in the fact that our employees are committed to providing a stable, reliable and competitively priced source of workers' compensation insurance for Montana businesses. We achieve this by setting realistic business goals, while at the same time challenging ourselves to "stretch" and improve operational efficiencies and respond to customer needs, wants and expectations.

This past year, we undertook a number of innovative strategic initiatives to provide cost-effective claim management, improve our technical capabilities and above all, deliver the best possible service to our customers. The results are highlighted throughout this report.

At this time I would also like to recognize my fellow board members for their commitment of time and energy to make Montana State Fund the industry leader in workers' compensation insurance in our state. Our success in the past and our continued progress in the future are dependent upon our collective ability to anticipate and respond rapidly to service expectations and industry change.

We look forward to your continued support.

A handwritten signature in black ink, appearing to read "Ed Henrich". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

Ed Henrich, Chairman

(Cover) **When jockey Elaine Ward was injured, she discovered the difference we make.** When Elaine was paralyzed in a fall, her life changed dramatically and inconceivably. Our team has been there, providing not only compensation, but also support, advice and information. We make that same difference in the lives of thousands of Montana workers who are injured on the job each year. Yes, workers' compensation is about money. But more so, it is about life.

President's Message

I think it is appropriate to pause and reflect on what sets Montana State Fund apart from other insurers in Montana. Our shared vision speaks of caring individuals working together in an atmosphere of creativity and trust. Since joining MSF, I've seen this in action. I've seen that the constant in all we do is the quality of our people. And I am a better person and President because of their talents, compassion, commitment and vision.

Each year our executives and team leaders collaborate on crafting an action plan for the coming fiscal year. Strategic planning is a disciplined effort to produce fundamental decisions and actions; these actions shape and guide what an organization is, what it does, and why it does it, with a focus on the future. The process involves making tough decisions about what is most important for our customers while maintaining our financial stability.

We have learned as an organization to imagine our future and set reachable goals, but also to be honest with ourselves and evaluate those areas in which we see obstacles and challenges. During this past year, we launched a number of customer-driven, cost-effective programs that reinforce our commitment to making a difference for all Montanans.

(continued on page 4)



Laurence Hubbard, President/CEO

(continued from page 3)

What Makes Workers' Compensation Different?

Workers' compensation benefits are defined in law for both indemnity (wage loss) and medical payments. However, unlike medical insurance, there are no caps on medical benefits. Our premiums are set long before the number, severity, duration or cost of claims can be known. For claims incurred in any given year, it takes about 30 to 40 years before the last dollar is paid out. For this reason, workers' compensation is known as a "long-tailed line of insurance."

Most claims close within three years, but the small number which remain open beyond that point account for more than half of the total costs. Catastrophic and/or unanticipated events which are not financially covered by annual premiums can also occur. For that reason, we must maintain significant reserves and contingency funds to ensure that we meet the needs of policyholders and injured workers. Another distinguishing feature of MSF is our status as the guaranteed market. Unlike other insurers who can pick and choose customers, MSF cannot refuse any Montana business. With this in mind, I am very proud to present our accomplishments for FY06.

It's in the Numbers

Once again, I am pleased to report that MSF achieved a net operating income for FY06. We saw our net earned premium grow by 11.9 percent, exceeding \$211 million. For the eighth consecutive year, our board declared a dividend (\$5 million), which

was distributed to more than 18,000 policyholders with superior safety records. Our investment income continued to grow, topping \$32 million. We also increased our loss reserves by \$79 million bringing the total to \$590 million. While this is a significant amount of money, workers' compensation carriers must maintain adequate case and contingency reserves to ensure the ability to meet long-term obligations.

It is also gratifying that we were able to improve our net worth by \$15 million to \$163 million. Often referred to as "surplus" in the insurance industry, funds in excess of reserves are really contingent liability funds available to deal with future, unanticipated liabilities. By maintaining adequate reserves and a strong net worth based on insurance industry best practices, we are able to continue to operate as a stable, financially strong and long-term viable carrier, committed to the people of Montana.

With that said, we continue to see an escalation in medical costs that shows no sign of abating. Medical inflation has become one of the major issues facing all workers' compensation insurers. Advancements in treatments, new technologies, and increases in physical medicine and pharmaceutical utilization have combined to increase medical costs beyond previously anticipated levels, and these costs will continue to challenge us into the foreseeable future.

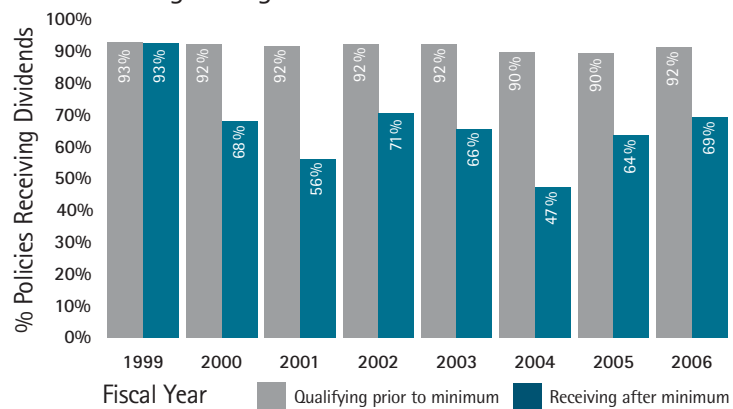
(continued on page 6)

Mark Meisner is continually working to improve our operational efficiencies through IT solutions.

The volume of claims information processed at Montana State Fund each day is mind-boggling. Thanks to advanced software and systems, and specialists like Mark, it is also efficiently managed. For example, our new ClaimCenter software helps us improve our claims processing so our claims' examiners can focus on helping injured workers and delivering positive outcomes.

Customers Receiving Dividends

Percentage of MSF Customers Receiving a Dividend among all Eligible Customers



Since 1999, when MSF began issuing dividends to its policyholders, over 90% of eligible policyholders qualified to receive a dividend prior to application of the minimum dividend. Two-thirds of MSF customers have actually received a dividend each year. Dividends cannot be guaranteed and are contingent upon MSF maintaining a strong financial condition in future years.

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Our Investment in People

Beyond our fiduciary responsibility we have a social obligation to keep Montana's workers safe, while helping policyholders control costs. Our Young Workers' Safety Rocks campaign implemented this year reflects just that. Through innovative materials and a website, employers have the information they need to talk safety with younger employees. The delivery of better customer service is another area in which we invested our energies in FY06. Our "One Touch" initiative allowed our employees to delve deeper into customer service, creating programs that better serve our clients. Another successful change last year was our new recruitment and retention philosophy. We have now set our sights on a larger pool of qualified employee candidates and created an in-house claims examiner trainee program. This mind-set ensures we have the best trained workers' compensation professionals in the state. Finally, the implementation of a new claim management system will enhance the productivity of our claims' examiners, improve overall claims outcomes, and provide better management information.

Governor's Workers' Compensation Study

Many have commented that workers' compensation insurance costs in Montana are higher than in other states, yet the reasons behind that are not well understood. In an effort to objectively compare our workers' compensation system (benefits, costs and premiums) to other states, Governor Brian Schweitzer

charged Lieutenant Governor John Bohlinger to spearhead the Workers' Compensation Study Project in 2006. The goal is to provide Montana's policy makers with a benchmark data comparison with other similar states and determine which factors drive insurance costs. We have played an active role in this process and commend the Lieutenant Governor and the Department of Labor and Industry for taking on this important task.

The Impact of Court Decisions

At this time, there are a number of court cases in various stages of the judicial process that could result in a significant change to our state's workers' compensation system. Pending cases are challenging the constitutionality of certain benefit laws. Should those challenges succeed, insurers may be obligated to pay hundreds of millions of dollars in retroactive benefits for which no premium had been collected. Should this occur, the legislature will need to consider options for bringing certainty, stability and predictability back into the law.

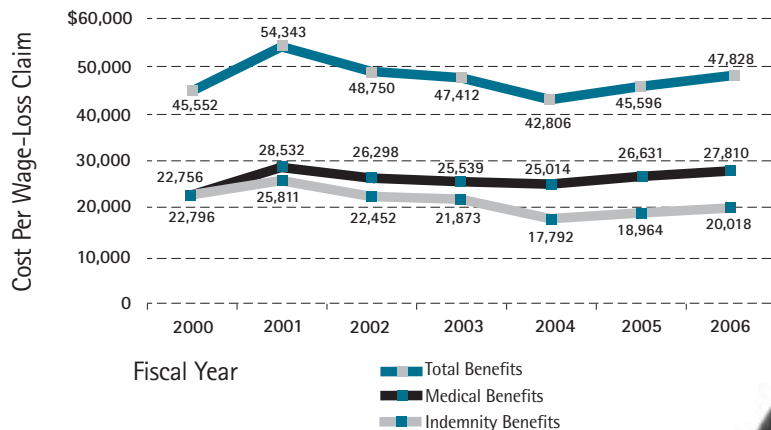
I would like to extend my sincere gratitude to our board of directors. These dedicated men and women volunteer to oversee the sound operation of MSF. I salute their enthusiasm and am honored to work with them.



Laurence Hubbard, President/CEO

Claim Medical and Contract Specialists like Bridget McGregor extend our "One Touch" philosophy to medical providers. Medical providers are essential to the service we deliver to Montanans. So naturally, we extend our philosophy of customer service to our medical partners, looking for ways to make their jobs and lives easier. In 2006, that focus on service and efficiency resulted in medical providers being paid faster than in past years.

Average Cost Per Wage-Loss Claim



Current estimates indicate that average claim costs have been on a slight downward trend compared to previous years. We know that general medical costs have been rising and that wage-loss benefits rise by the rate of wage inflation. We believe that the downward trend reflects operational improvements in MSF's claims management, getting injured workers back to work more quickly.

Difference Makers

As a company, our goal is to be the insurance carrier of choice and industry leader in service for Montana's business owners and their employees. Individually, it is a much simpler goal—to make a difference. If we can go home at day's end knowing we have made a positive difference in the lives of our customers, we have done our job. It means we have fulfilled their needs and lived up to their expectations. We've delivered on our core promise of excellent service—one claim, one worker and one customer at a time.

Solving Unique Challenges

Making a difference begins by understanding the challenges our policyholders and their employees face daily. To that end, we create unique safety programs that specifically target key customer segments. Our Young Workers' Safety Rocks campaign is an excellent example. We found that workers age 16 to 24, who comprise just 15 percent of our workforce, were accounting for 22 percent of our claims. To get our message past the media clutter and capture the imagination of this young audience, we developed a comprehensive marketing campaign featuring billboards and a website (www.safetyrocks.us) that discuss safety in a youthful, relevant way. We also developed a safety kit that gave employers tools to improve safety awareness among younger employees. This innovative program, which included giving away an iPod, received statewide media attention.

Making Workplaces Safer

One of the best ways to control workplace accidents is to provide policyholders updated safety materials and innovative training solutions. Our dedicated safety specialists collectively log thousands of miles across the state to conduct safety workshops and provide one-on-one consultations. In FY06, our free, half-day workshops were attended by 1,163 Montana employers and covered topics such as accident investigation, Return to Work programs and writing effective safety plans. It is a difference our policyholders see in the form of improved safety records, reductions in work-loss incidents, stable rates and year-end dividends.

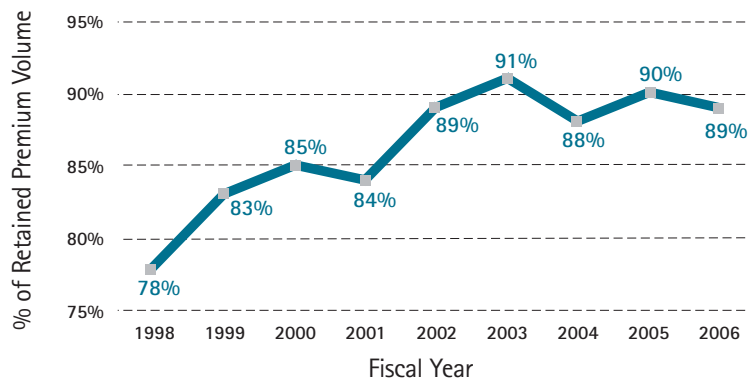
Improving Business Efficiency

Much of our energy in FY06 was concentrated on improving operational efficiencies. For example, we launched **ClaimCenter**, workers' compensation software that enables our staff to effectively manage claims while improving claim outcomes. We also dedicated significant time to refining a number of technological services with a goal of streamlining and speeding up business operations. In addition, we are working to more efficiently connect with customers through e-business. We continue to fine-tune our website (montanastatefund.com), and add functionality to enable customers to conduct business transactions online.

Britani Laughery helps policyholders prevent claims by preventing injuries.

Preventing claims is a key difference maker in insurance costs for Montanans. Toward that end, our safety team made on-site visits to more than 1,800 businesses in FY06. They also developed specialized training programs for high-risk jobs — including one for professionals who work with the mentally ill and developmentally disabled. It helped reduce the risk of injury for caregivers and their patients.

Premium Retention Rate



In the soft market conditions of the late 1990s, MSF's retention of written premium was relatively low by industry standards. However, in the last few years as market conditions have changed and MSF has established itself as the industry leader in service and carrier of choice in Montana, our retention of written premium has dramatically improved. In recent years, we typically retain about 90% of our business from year to year, based on premium dollars.

STATUTORY STATEMENTS OF ADMITTED ASSETS, LIABILITIES, AND EQUITY

as of June 30,

ADMITTED ASSETS

	<u>2006</u>	<u>2005</u>
INVESTMENTS		
Bonds	\$ 668,698,440	\$ 565,851,046
Equity Securities	83,377,362	76,737,097
Cash and Short-Term Investments	14,919,072	32,157,356
Other Investments - Collateral Securities on Loan	<u>132,438,892</u>	<u>101,859,456</u>
Total Investments and Cash	899,433,766	776,604,955
OTHER ADMITTED ASSETS		
Premium Receivables	11,592,290	9,655,653
Equipment (net)	1,266,139	786,673
Interest Receivable	9,466,862	8,206,869
Other Assets	<u>15,771,861</u>	<u>6,569,389</u>
Total Admitted Assets	<u>\$ 937,530,918</u>	<u>\$ 801,823,539</u>

LIABILITIES AND EQUITY

LIABILITIES

Losses Incurred Reserves	\$ 535,114,000	\$ 464,564,000
Loss Adjustment Expense Reserves	55,574,000	46,993,000
Liability for Securities on Loan	132,438,892	101,859,456
Deferred Revenue	2,106,613	4,925,828
Other Liabilities	<u>49,195,918</u>	<u>35,127,384</u>
Total Liabilities	774,429,423	653,469,668

CONTINGENCIES AND SUBSEQUENT EVENTS

EQUITY

Policyholders' Equity	<u>163,101,495</u>	<u>148,353,871</u>
Total Liabilities and Equity	<u>\$ 937,530,918</u>	<u>\$ 801,823,539</u>

STATUTORY STATEMENTS OF REVENUE AND EXPENSES AND CHANGES IN EQUITY

for the years ended June 30,

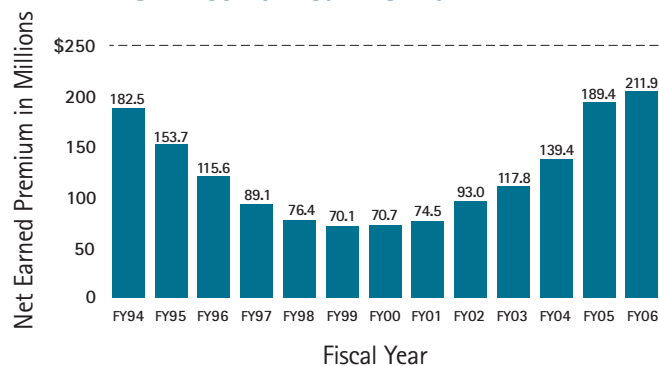
	<u>2006</u>	<u>2005</u>
Net Premium Earned	\$ 211,892,198	\$ 189,378,858
Losses Incurred	(180,614,395)	(152,545,131)
Loss Expenses Incurred	(25,223,629)	(20,185,786)
Underwriting Expenses Incurred	<u>(19,344,047)</u>	<u>(21,638,784)</u>
Net Underwriting Loss	(13,289,873)	(4,990,843)
Net Investment Income Earned	32,440,146	29,125,416
Net Realized Capital Gains (Losses)	(255,892)	1,041,886
Premium Balances Charged Off	(2,791,527)	(843,697)
Other Expenses	<u>(981,233)</u>	<u>(496,036)</u>
Net Income Before Dividends	15,121,621	23,836,726
Policyholder Dividends	<u>(5,001,042)</u>	<u>(5,004,416)</u>
Net Income After Dividends	10,120,579	18,832,310
Prior Year End Equity	148,353,871	127,492,156
Net Unrealized Gains on Equity Securities	6,640,265	4,598,723
Change in Non-admitted Assets	(2,012,516)	(2,522,786)
Aggregate Write In for Other Losses	<u>(704)</u>	<u>(46,532)</u>
END OF PERIOD EQUITY	<u>\$ 163,101,495</u>	<u>\$ 148,353,871</u>

The complete financial statements, including the accompanying notes, are available upon request.

Jeff Bryant in underwriting assesses the changing risks of jobs and ensures policyholders are adequately covered.

Risk sets insurance premiums. In Montana's competitive market, that puts a great deal of emphasis on the abilities of underwriters. Set premiums too high for the risk, and customers will go elsewhere. Set them too low, and injury costs won't be adequately covered. Our team of underwriters was up to the task in FY06, resulting in net earned premium growth and dividends paid to more than 18,000 policyholders.

MSF Net Earned Premium



MSF premium declined from approximately \$182 million in 1994 to \$70 million in 1999. Since 1999, net earned premium has significantly risen as market conditions have changed and rates have increased to cover the increasing cost of claims.

Report of Management

The management of Montana State Fund (MSF) is responsible for the financial statements and all other information presented in this annual report. MSF maintains a system of internal controls designed to provide reasonable assurance that assets are safeguarded against loss and that transactions are executed and recorded in accordance with management's authorization. This system encompasses the organizational structure, selection and training of personnel, communication and enforcement of policies and procedures, and ongoing internal and external audit programs. Internal controls are continually reviewed and evaluated by management.

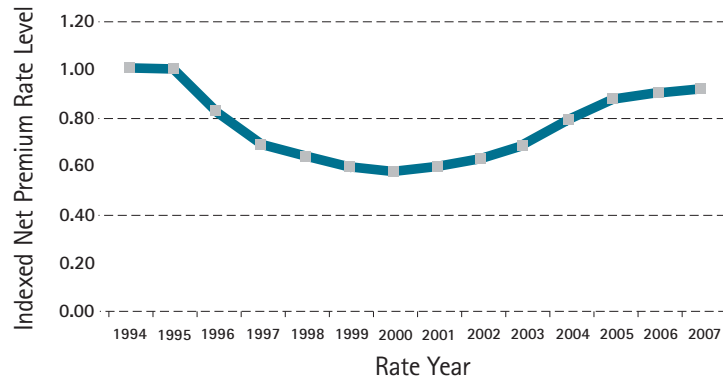
The financial statements are presented for our fiscal year ending June 30, 2006 and 2005 and include amounts based on the best estimates and judgments of management. These financial results are presented on a statutory basis, which is consistent with insurance industry financial statement presentation. MSF governs, operates and completes its financial reporting as an insurance company domiciled in the state of Montana, and its financial statements are presented on the basis of accounting practices prescribed or permitted by the Montana State Auditor.

The statements included in this annual report should not be considered complete audited financial statements. The statements presented are representative of audited financial statements as audited by an independent public accounting firm. An unqualified, or clean, opinion was issued on MSF's statutory financial

statements. The complete audited financial statements including the accompanying notes are available upon request. The preparation and independent external audit of statutory financial statements is discretionary on the part of MSF, but one that is seen as important. Evaluating the financial results of MSF in comparison to other insurers aids in assessing and maintaining the financial security and stability of MSF as a workers' compensation insurer. In addition, MSF is a component unit of the state of Montana. As required in law, the Legislative Audit Division (LAD) of the state of Montana conducts independent audits of financial statements of MSF presented in accordance with generally accepted accounting principles (GAAP) as prescribed by the Governmental Accounting Standards Board (GASB). For the financial periods ending June 30, 2006 and 2005, MSF received an unqualified audit opinion from the LAD. The audited governmental financial statements and the related audit opinion are issued under separate cover. To obtain a copy of the full governmental financial statements, contact the Legislative Audit Division. The presentation of the statutory financial statements in this report differs from the governmental presentation basis (GASB). A financial reconciliation of equity between the audited GASB financial statements and the audited statutory financial statements presented in this report follows (page 14).

As an actuary, Dan Gengler helps ensure our financial stability by looking into the future. Shifts in the industry, legislative actions, unforeseen medical inflation and even catastrophic incidents play roles in the current cost of insurance and future pay-outs. To ensure that our commitments to Montanans are met, MSF maintains a sizeable financial reserve. With the work of actuaries, like Dan, we've been able to build a strong reserve and solid financial foundation — a difference Montanans will see for decades to come.

MSF Rate Level



MSF rate levels significantly decreased from 1994 to 2000 due to improved conditions in the workers' compensation arena, including lower medical inflation, declining claim frequency, and statutory benefit changes beginning in 1996. Rate levels bottomed out in 2000 and are now rising due to increased medical costs and statutory and judicial benefit expansions. Current rates are about 9% below 1994 rates.

A Comparison of GASB to Statutory Accounting Ending Equity for the Year ended June 30, 2006 (in 000's):

Governmental Accounting (GASB) Ending Equity	\$157,585
Reconciling Items:	
Unrealized Gain on Fixed Income Securities	(344)
Net Effect of Cumulative Unrealized Loss on Equity Securities	14,971
Net Effect of Cumulative Change in Non-Admitted Assets	(9,680)
Other (Deferred Acquisition Costs, etc.)	569
Statutory Accounting Ending Equity	\$163,101

Quick Facts as of June 30, 2006

Total Earned Premium	\$211,892,198
Number of Policies Serviced	32,367
Total Number of Claims Processed	15,357
Number of FTEs	293.5
Investment Income	\$32,184,254
Net Income	\$10,120,579
Policyholders Dividend	\$5,001,042
Loss and LAE Reserves	\$590,688,000
Equity	\$163,101,495
Reserves to Equity Ratio (after dividend)	3.62
Premium to Equity Ratio (after dividend)	1.3

Board of Directors



Jane DeBruycker
Dutton



Joe Dwyer
Billings



Ed Henrich
Fairmont



Laurence Hubbard
Ex-Officio, Helena



Ken Johnson
Missoula



Mardi Madsen
Billings



James Swanson
Glendive



Lawrence Zanto
Helena

Executive Team

Standing, back: Tony Johnson, Vice President, Human Resources; Al Parisian, Chief Information Officer; Nancy Butler, General Counsel; Layne Kertamus, Vice President, Insurance Operations

Seated, front: Laurence Hubbard, President; Peter Strauss, Vice President, Insurance Operations Support; Mark Barry, Vice President, Corporate Support

Not pictured: Sherrie Handel, Special Assistant to the President



Highlights

- MSF awarded a dividend for the eighth consecutive year. Since 1999, \$41 million has been returned to deserving policyholders with superior safety records.
- Our charitable giving program, ACE (Assisting Charitable Endeavors), awarded \$43,875 to 19 worthy projects. ACE makes matching funds available to Montana nonprofit organizations that contribute to safety and community well-being in our state.
- The efforts of our Special Investigations Unit to uncover fraudulent claims have saved nearly \$29 million since the program's inception in 1993.
- 1,163 Montana employers attended 88 MSF safety trainings held throughout the state. That's a 17% participation increase over 2005.
- Our Safety Management Consultants visited 1,842 policyholders last year — 120 more visits than the previous year.
- Our recruitment video received a second-place award in the Audio/Visual Production category from the American Association of State Compensation Insurance Funds.
- "Psychological Issues in Workers' Compensation Injuries" was the topic for our fifth annual medical education conference. More than 100 medical providers and workers' compensation professionals from across Montana attended the daylong seminar.
- Our scholarship program assists children and spouses of workers fatally injured in a work-related accident. Twelve scholarships were awarded in 2006. While nothing can replace the untimely loss of a loved one, our scholarship program provides an additional benefit for those most affected by significant loss.

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